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Indonesia: from showcase to basket case

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The repercussions of the East Asian financial crisis have been the most severe in Indonesia, a country long regarded as one of the developing world's greatest success stories. Although triggered by external factors, the roots of the economic collapse can be traced to a series of policy errors and to the nature of economic policy-making under Suharto. The article reviews the factors leading to the intensification of the crisis, including the attempt of a weak, 'patrimonial' Indonesian state to carry out a wide-ranging programme of financial liberalisation. The reforms failed to dismantle the patron–client system and increased the risks of financial crash.

Introduction

In the year since the onset of the East Asian financial crisis a diverse set of national crises has begun to take shape. Among these, Indonesia's is by far the most severe. National income is expected to contract in 1998 by between 10 and 15%, and the decline is likely to extend into 1999.[1] According to recent government estimates, the proportion of the population below the poverty line has risen to 40%, and 15 million workers have lost their jobs (Thoenes, 1998B).[2] A severe drought has complicated matters, driving up food prices and causing shortages in some locations.[3] The banking system is essentially defunct, suppressing exports and reducing whole industries to resort to barter as the last remaining source of working capital.[4] The nation's currency, the rupiah, was still trading in July at around 15 thousand to the US dollar, levels at which it ceases to function as a meaningful store of economic value.

Like Thailand and South Korea, the severity of Indonesia's economic crisis is all the

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[1] In June the IMF forecast a decline in GDP of 10% for the year (IMF, 1998, p. 1). Goldman Sachs predicts a 15% contraction, as compared to 6% and 1·9% in Thailand and South Korea, respectively (Sender, 1998, p. 63).

[2] These figures were reported by the Central Bureau of Statistics (CBS), which estimated the incidence of poverty before the crisis at 11·3% of the population (Solomon, 1998). This is most likely an underestimate given that CBS has set the poverty line at the low levels of Rp 227,720 per family per month in urban areas and Rp 177,997 in the countryside. At the current rate of exchange these poverty lines are equivalent to US$15·25 and $11·90, respectively.

[3] The problem of food shortages has been compounded by anti-Chinese violence that has disrupted normal distribution networks.

[4] Footwear exports, for example, have declined sharply despite a backlog of one billion dollars worth of orders. Companies are unable to organise trade credits or obtain foreign exchange for the purchase of inputs (Radelet and Sachs, 1998B, p. 35). Total exports fell from US$4·2 billion in July 1997 to $1·4 billion in March of 1998.

more remarkable because of the country's successful record of development. Grouped as one of its 'East Asian Miracle' economies, Indonesia has for years been a favoured client of the World Bank, frequently held up as an example of the benefits of market-oriented reforms (World Bank, 1993).[1] Real GDP growth averaged 6·6% per annum over three decades, and average real incomes in the bottom quintile of the population nearly trebled over the same period. Growth in recent years has been spurred by an emergent industrial sector that expanded at an annual rate in excess of 10% from 1990 to 1995.

In an attempt to explain this sudden turnaround, economists have identified a number of factors that contributed to the onset of the crisis and the subsequent deepening of economic distress. These include over-reliance on short-term overseas borrowing, inherent instability in global financial markets (Radelet and Sachs, 1998A), under-regulated and poorly monitored domestic financial systems (Stiglitz, 1998), and moral hazard resulting from 'patrimonial' ('crony capitalist') relations between Asian governments and big businesses (Krugman, 1998). Added to these are policy errors made by governments and the International Monetary Fund during the early stages of the panic (Feldstein, 1997; Wade and Veneroso, 1998), and political uncertainty resulting from mounting pressure on weak or non-existent democratic institutions.

All of these factors were at play in the Indonesian case to varying degrees. We should not lose sight of the fact, however, that, much like the 'Asian miracle' that preceded it, the current crisis is in fact not one but several distinct national crises sharing a common external environment. This essay represents an early attempt to situate these various factors within the context of the Indonesian political economy. It is now generally agreed that the onset of the crisis was due to over-reliance on short-term borrowing followed by an unexpected and massive outflow of capital in the second half of 1997. However, we shall argue that the *intensity* of the crisis in Indonesia owes more to a series of policy errors and to the nature of the state and economic policy-making under the Suharto regime. More specifically, we trace the roots of the collapse to the attempt, beginning in the 1980s, of a weak, patrimonial[2] Indonesian state to carry out a wide-ranging programme of economic liberalisation.

Two important consequences arise from the inherent contradiction between patromonialism, limited state capacities, and the liberalisation effort. First, although economic ministers (or 'technocrats' as they are generally known) did at times possess sufficient influence to enact wide-ranging reforms, they lacked the power to enforce new rules, or to build the required supervisory and regulatory powers within the bureaucratic apparatus. Second, the orthodox strategy pursued by the technocrats succeeded mainly in weakening their own control over fiscal and monetary policy. Paradoxically, although successive rounds of liberalisation failed to achieve their stated objective of reducing the level of rents in the system, they had the unintended effect of limiting the technocrats' capacity to intervene in a meaningful way to adjust to external shocks.

The rest of the essay is organised as follows. The next section recounts the events of the deepening crisis, and in doing so points out how weaknesses in the banking sector and a series of policy errors plunged the economy into depression. This is followed by a

[1] A 1992 World Bank report cited Indonesia as 'one of the Bank's greatest success stories overall in the 1980s', and that '[t]he impressive growth of Indonesian industry was a testimony, among other things, to the Bank's sound analysis, advice and influence' (World Bank, 1992, cited in McIntyre 1994, p. 264).

[2] 'Patrimonialism' refers to a style in which vertical patron–client relations, primarily between the bureacratic apparatus and business, take precedence over other forms of political mobilisation and control (see MacIntyre, 1994, for a discussion of patrimonialism in the Indonesian context).

discussion of the nature and sequencing of the financial reforms, and the role of the liberalisation process in creating the conditions that led to the current crisis. The paper concludes with some comments on prospects for recovery and restructuring of the state in post-Suharto Indonesia.

1. The onset of the crisis

When the Thai government allowed the baht to float in July 1997, Indonesia's position appeared to be relatively strong. Trouble had been expected in Thailand for some time, and the government had taken steps to withstand the probable contagion effects. As recently as June 1997 the country was still winning praise from the IMF for 'prudent macroeconomic policies, high investment and savings rates, and reforms to liberalise markets' (Wessel *et al.*, 1997). Despite some concerns over weaknesses in the banking system and a slight slowdown in non-oil export growth, the general prognosis remained positive (World Bank, 1997). There had been no major corporate bankruptcies analogous to the Hanbo collapse in Korea. The 1996 current-account deficit of 3·5% was comparable to previous years, and less than half the level in Thailand. The government had maintained a nominal budget surplus equivalent to 1% of GDP for the previous four years, and Bank Indonesia (BI) had substantially increased its stocks of international reserves. BI had also entered into a number of stand-by agreements with neighbouring countries, including Japan (World Bank, 1997, p. 16). The rupiah trading band was widened twice in 1996, moves intended to improve Indonesia's capacity to adjust quickly to an external shock.

The first real signs of danger appeared in early August 1997 with renewed pressure on the rupiah. The government took immediate action to dampen what was generally considered to be a serious, but temporary, speculative burst against the currency. BI abandoned the rupiah trading band, raised its three-month interest rate from 11 to 28% and intervened massively in the foreign exchange markets. The ministry of finance announced the postponement of investment projects worth about US$16 billion.

With the benefit of hindsight we know that the problem was neither confined to speculation nor temporary. According to the Bank for International Settlements, US$34·2 billion of Indonesia's total private foreign debt of US$55 billion—equivalent to 16% of GDP—was due to mature in less than one year. From the end of 1995 to mid-1997, Indonesian firms had doubled their exposure to take advantage of the spread between international and domestic interest rates. Not only had the government failed to curb excessive borrowing, but Bank Indonesia was unaware of the scale of overborrowing or the fact that most of the short-term credits were unhedged against exchange-rate risk (Wessel *et al.*, 1997).

The extent of overborrowing was symptomatic of deeper pathologies in the financial system. A decade of banking reforms beginning in 1983 had removed most controls on interest rates, entry, credit allocation and had lowered reserve requirements. By the early 1990s, Indonesia possessed one of the most liberal banking systems in the world. Bank credit expanded rapidly as the number of institutions mushroomed to over 240. The private banks were particularly aggressive, expanding credit at an annual rate of over 40% from 1988 to 1996. Both the legal framework and supervisory capacity lagged behind this rapid growth, with some predictable results. Non-performing loans exceeded 12 billion dollars according to 1996 official statistics, although this is almost certainly an underestimate (World Bank, 1997, p. 128). A series of spectacular bank failures in the

1990s underscored the fragility of the banks' balance sheets (Cole and Slade, 1996, p. 135).

Demand for dollars continued to build as domestic bank and non-financial firms scrambled to cover their foreign exchange positions, and it become clear that new credits were not forthcoming.[1] For the five countries most affected by the crisis, Radelet and Sachs estimate the net outflow of commercial bank lending in the second half of 1997 at US$34 billion.[2] They compare this to a net inflow of $55·5 billion in 1996 and $13 billion for the first six months of 1997 (1998A, p. 6). This sudden shift in the availability of foreign credits placed Indonesian banks, already weakened by non-performing loans, in immediate distress. Since the banks were themselves large-scale dollar borrowers, currency depreciation resulted in a contraction of bank capital. Domestic borrowers found that they were unable to roll over their short-term loans, and were forced into default.

Rising interest rates only made it more difficult for banks and non-bank firms to meet their short-term obligations. Ironically, while the government's official policy emphasised squeezing domestic liquidity to shore up the exchange rate, in its capacity as guardian of the state banking system BI was quietly injecting liquidity into the system to forestall a wholesale collapse. An estimated Rp 80 trillion (the equivalent of $30 billion at the pre-crisis exchange rate) were released between July and February.[3] In the context of an open capital account, this effective monetary expansion nullified the effects of the interest rate rises but could not save the state banks from default.

In September the government went further, installing what BI Governor Sudradjad Djiwandono called 'a self-imposed IMF programme', including the cancellation of $62 billion worth of investment projects, another liquidity shock and a promise to shut down insolvent banks (Thoenes, 1998A). But by then the first defaults on private foreign debt had been announced, and foreign and domestic investors, realising the scale of the crisis, were crowding the exits. After a temporary respite, the rupiah again came under pressure, and the government called in the IMF on 8 October.

The three-year, $23 billion IMF programme signed on 31 October fared no better than BI's self-imposed austerity measures. Like the Thai and Korean plans, Indonesia's recovery plan called for maintenance of a fiscal surplus equivalent to 1% of GDP, bank closures and high interest rates. Capitalising on its new-found bargaining power, the IMF also insisted on a comprehensive backlog of reforms including the winding-up of domestic monopolies closely associated with the Suharto family. As critics of the IMF have noted, many of the structural reforms—although desirable over the medium term—were unrelated to the immediate problem of overcoming the country's short-term liquidity crisis (Feldstein, 1998, p. 24). Their inclusion constituted a direct confrontation with Suharto that the President came to view—correctly, as it turns out—as a challenge to his leadership.[4] IMF demands for an end to fuel subsidies that mainly benefit the urban lower

[1] In contrast to Korea, about three-quarters of private overseas debt in Indonesia was held by non-bank firms. However, since every major conglomerate operates a private bank, the distinction in most cases is not particularly meaningful. Pressure on the banks was also amplified by the sheer extent to which they had violated prudential bank rules. The first audits undertaken by the Indonesian Bank Restructuring Agency (IBRA) have revealed that Indonesian banks were trading heavily in repurchase agreements and complex foreign currency derivatives, and that some banks were exposed to single borrowers beyond the 20% lending limit set by BI (Witcher, 1998).

[2] The five countries are Korea, Thailand, the Philippines, Malaysia and Indonesia.

[3] One result was that the IMF, which had been tracking base money, changed its monitoring criteria to Net Domestic Assets as part of the third agreement with the government in January 1998.

[4] Suharto reportedly told former Vice-President Walter Mondale, in Jakarta as a special US emissary to urge implementation of the package: 'If I do these things, they will throw me out of office' (Sanger, 1998).

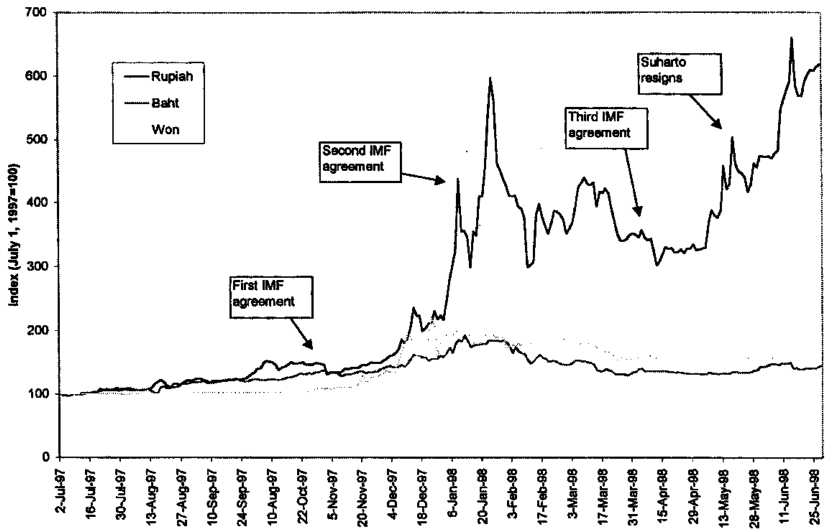

Fig. 1. *Exchange rate indices, July 1997 to June 1998 (1 July 1997 = 100).*

and middle classes were also politically naive, as was demonstrated in May 1998 when the attempt to finally implement this provision sparked the chaos that eventually led to Suharto's resignation.

The immediate cause of the programme's collapse, however, was bank liquidation. On 1 November the government closed 16 private banks in line with the agreement. With public confidence in the banking system already low, failure to publish the criteria used in deciding which banks would close sparked a generalised bank run as depositors scrambled to retrieve their savings.[1] An announcement that deposits would be guaranteed only up to a level of $5,000 contributed to the panic. Confidence in Suharto's resolve to implement the IMF programme was further undermined when his second son, Bambang Trihatmodjo, was allowed to acquire the licence of a second bank which he used to continue operations from the same premises of his closed Bank Andromeda. The government also reversed its previous decision to postpone 15 infrastructure projects with close connections to the Suharto family.

The wheels finally came off in mid-December when rumours that Suharto was seriously ill raised fears of imminent political instability. The rupiah broke the 10,000 to the dollar barrier on 6 January in the wake of IMF and US Treasury criticism of a draft budget ostensibly violating spending limits set in the agreement.[2] A new pact with the IMF later in the month collapsed in due course. But by then Suharto's continued presence was itself a destabilising factor, and the nation girded itself for what has turned out to be a prolonged, and painful, period of political transition.

[1] The legal basis for the bank closures was also unclear. The December 1996 regulations on bank liquidation had failed to set out clear criteria for closure, leaving the decision up to the discretion of the Ministry of Finance and Bank Indonesia (World Bank, 1997, p. 127).

[2] Radelet and Sachs point out that the proposed 32% budget increase was mainly due to exchange rate movements, and thus did not justify the harsh reactions that it attracted from the IMF and US Treasury. 'Within three weeks', they wrote, 'the Fund had quietly approved a new budget with a 46% increase in spending, but the damage to market perceptions had been done' (1998A, p. 23, fn. 11).

What is most notable about the second agreement (as well as the third in April and fourth under President Habibie) is the doggedness with which the IMF has held to its original programme. Although fiscal targets have been relaxed because of the continued weakness of the rupiah and a decline in oil prices, the IMF still insists that 'tight monetary policy continues to be essential if the exchange rate is to stabilize and inflation decline' (IMF, 1998, p. 2). Yet 11 months after the first interest rate hike the rupiah is still trading at around 15% of its pre-crisis value and prices are rising at an annual rate of 80% (Figure 2). As Radalet and Sachs conclude, the proposition that high interest rates could stabilise the rupiah has been tested and proved incorrect (1998B, p. 36). Continuing along this course only serves to undermine the credibility of the IMF, which in Indonesia—and to a lesser extent in Thailand and Korea—has left itself open to the charge that its strategy amounts to little more than halting the progress of the disease by killing the patient.

2. 'Putting the cart before the horse'

Financial liberalisation was a central plank of the neo-liberal resurgence in development policy. Yet by the early 1980s the experiences of Argentina, Chile and Uruguay—where deregulation had been followed by rapid credit expansion, a build-up of short-term foreign debt and bank failures—had dampened earlier enthusiasm for the benefits of 'unrepressed' financial systems. In response, the main proponents of liberalisation emphasised the importance of ordering the various phases of deregulation correctly. Deregulation of domestic and international trade should precede financial deregulation, with full convertibiltiy on the capital account coming in the final stages of the process (McKinnon, 1993).

Indonesia has often been cited as an example of a country that has pursued an idiosyncratic ordering of deregulation with no apparent ill effects (Cole and Slade, 1996, p. 356). In *The East Asian Miracle,* The World Bank praised Indonesia's financial reforms

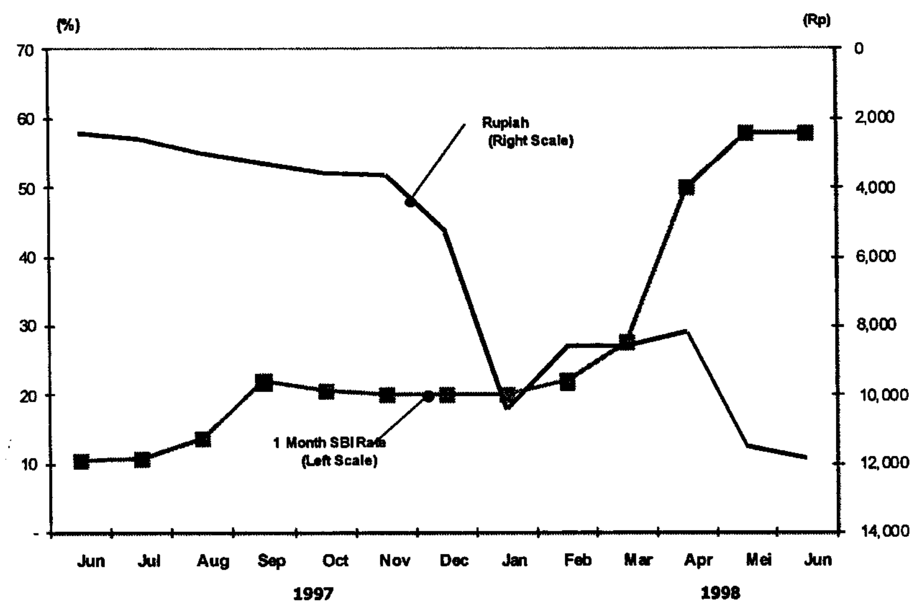

Fig. 2. *One month SBI rate and dollar exchange rate.*

in a section entitled, without apparent irony, 'Indonesia Moves Ahead by Putting the Cart Before the Horse' (1993, p. 238). Flouting the conventional wisdom, Indonesia had opened its capital account in the early 1970s, followed by radical bank deregulation in the 1980s. Meanwhile monopolies and cartels still dominated key non-financial domestic markets. Anxious to support any form of deregulation in Indonesia, the World Bank applauded Indonesia's unorthodox approach and concluded that the opening of the financial system would stimulate deregulation of the real side of the economy and thus propel the process of economic growth.[1]

The pace and sequencing of liberalisation in Indonesia had in fact less to do with theoretical debates in economics than with the political isolation and powerlessness of the technocrats. Like the crony capitalists and self-styled 'nationalists' (including the newly appointed president, B. J. Habibie) who opposed them, the technocrats depended entirely on their relationship with Suharto to implement their policy initiatives. This has often meant waiting for periodic economic crises when their influence was at its highest.[2] Moreover, their lack of an independent political base and patrician management style led them to rely heavily on measures that could be implemented through central directives. The result has been that liberalisation has proceeded in a piecemeal fashion, driven in fits and starts by immediate political opportunities and lacking a coherent medium-term strategy or assessment of risks (Winters, 1998).

An example is the balanced budget law, adopted in the early years of the regime to prevent a return to the huge fiscal deficits characteristic of the Sukarno government of the 1960s. The law itself does not in fact call for a balanced budget in the sense that revenues must equal expenditures, but only requires that deficits be covered by corresponding inflows of aid and overseas borrowing. Although largely devoid of economic meaning, the rule has performed a valuable *political* service for the technocrats, who—lacking direct influence on line ministries—needed an external constraint on total government spending. This victory, however, came at a cost: namely, the loss of meaningful adjustments to fiscal policy in the management of the economy. As Hill notes, 'Consequently, monetary policy and quantitative restrictions on bank credit (up to 1983) have been the primary instruments of short-run macroeconomic stabilisation' (Hill, 1996, p. 62).

Yet even as an approximate spending target, the impact of the balanced budget principle was more apparent than real. Suharto himself did not feel bound by the rule, and permitted substantial off-budget spending for political purposes. Examples include spending on electoral campaigns, and the use the so-called 'reforestation fund' to help finance a then Minister of Research and Technology Habibie's national jet project in 1994. The need continually to tighten liquidity to adjust for unplanned oscillations in fiscal policy was an important underlying cause of the persistent wedge between domestic and overseas interest rates, and hence the problem of overborrowing.

Much the same could be said for Indonesia's open capital account, introduced in 1970. The initial impetus for a unified, fully convertible exchange regime was the desire to avoid the problems of corruption and disincentives to trade that had plagued the Sukarno regime (*ibid*., p. 41). Convertibility can also be seen as part of the regime's implicit social compact with the politically weak Chinese–Indonesian community, which in time came to

[1] The Bank did not specify the mechanism through which this link between financial and real side deregulation would operate. In fact, cartelisation of domestic and international trade proved to be perfectly consistent with financial deregulation. Groups with access to trade and licensing privileges were more than happy to leverage their capital through entry into the banking sector.

[2] See Winters (1996) for a detailed description of the technocrats' political fortunes and misfortunes.

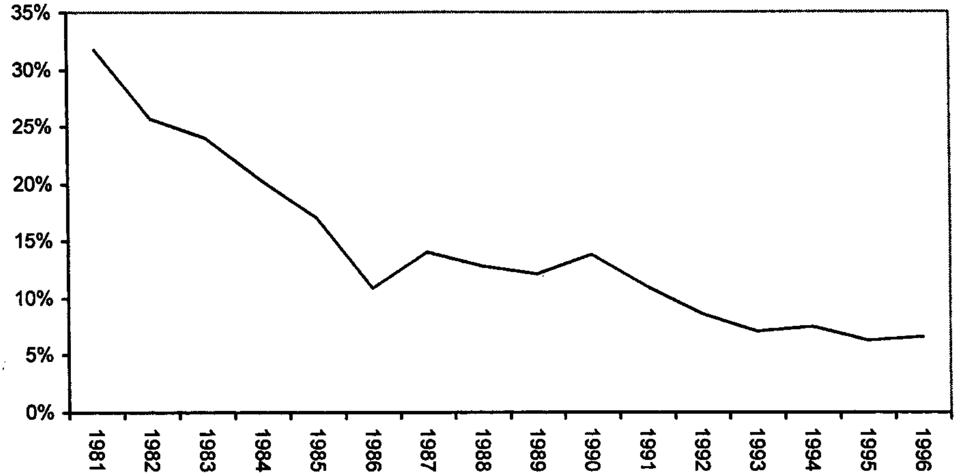

Fig. 3. *Net oil and gas exports and aid disbursements as share of GDP (1981–96).*

encompass the growing indigenous capitalist class. With little prospect of 'voice' in the political system beyond a limited number of well-connected individuals, the right to 'exit', financially at least, provided some insurance against arbitrary rule. Moreover, the technocrats viewed an open capital account, combined with a fixed exchange rate or crawling peg, as an additional means of imposing macroeconomic discipline on an unwieldy government structure. Again, this constraint placed a heavy burden on monetary policy and restrictions on the expansion of bank credits to adjust for exchange-rate shocks and unfavourable capital movements (Cole and Slade, 1996, p. 40).

Aside from a small number of isolated incidents, however, this would not emerge as a major problem in the 1970s and early 1980s owing to the sheer weight of the government in total foreign exchange transactions. This is illustrated in Figure 3, which shows net oil and gas revenues plus aid disbursements as a percentage of GDP. Combined with the state banks' dominance in the financial system, the government's leverage in the currency market imparted some protection against unfavourable exchange rate movements. This was lost with the advent of bank liberalisation and the fall of oil and aid receipts relative to private capital flows.

The banking reform of 1988 removed restrictions on opening new banks and branch offices, and sharply reduced reserve requirements. These measures followed the removal of bank credit and interest rate ceilings on state banks in 1983. The immediate intent of these reforms was to mobilise domestic sources of financing to replace oil revenues, which had fallen with the oil price in the 1980s. Unable to push through reform of the state banks, which remain an important source of funds for the patronage system, the technocrats instead opted for liberalisation to introduce more competition into the financial sector.[1]

The cumulative effect of deregulation was to leave Indonesia with one of the world's

[1] Symptomatic of the technocrats' frustration with their lack of control over state bank lending was the circulation of a list in 1994 of non-performing loans, in which members of the Suharto family figured prominently. It was widely acknowledged in Jakarta that the technocrats had leaked this document to draw attention to the perennial problem of uncontrolled patronage at the state banks.

most unregulated financial industries. Having eased entry and lowered capital requirements, banks were required to hold no more than about $16 million in capital. This created an environment in which banks were encouraged to take excessive risks, a problem compounded by lax supervision, inadequate accounting procedures, an absence of restraints on borrowing and lending practices and ambiguous procedures relating to bank liquidation. Although the technocrats understood the risks involved, by the early 1990s they no longer possessed sufficient influence with Suharto to regain control over the freewheeling banking system. An attempt in 1991 to limit foreign borrowing, for example, came to grief when second son Bambang and timber-baron Prajogo Pangestu managed to circumvent the new rules in launching the $1·8 billion Chandra Asri petrochemical project (MacIntyre, 1994, p. 260).

Successive rounds of deregulation have thus left the government with few remaining instruments to manage the economy and adjust to external shocks. Having surrendered control over capital movements, interest rates, credit creation and (to a large extent) fiscal policy, the monetary authorities were left with interest rates on Bank Indonesia securities (SBIs) and the exchange rate as the main levers of macroeconomic adjustment. The Finance Ministry's lack of control over fiscal expenditures under Indonesia's version of the balanced budget rule, virtually guaranteed that domestic interest rates would remain high as a counter to persistent inflationary pressures.

Combined with an open capital account, implicit government guarantees on deposits and persistently high domestic interest rates, the financial liberalisation amounted to a high-risk strategy that relied heavily on the confidence of domestic and foreign investors to paper over the system's underlying fragility. Devaluation of the currency was held out as a measure of last resort, a logical result of the country's huge foreign debt burden. Yet Bank Indonesia's reluctance to repeat the experience of the maxi-devaluations of the 1970s and early 1980s left the country vulnerable to periodic speculation against the rupiah. Beyond the crawling peg and exchange rate band, the government found that on occasion it had to rely on draconian liquidity shocks to shore up the value of the rupiah and contain runaway credit creation. In what became known as the 'Sumarlin Shock',[1] state enterprises were forced in June 1987 to withdraw time deposits from state banks and purchase SBIs from the central bank. Bank Indonesia also pressed private banks to buy their money market securities (SBPU),[2] which in effect forced them to sell foreign exchange to the central bank to meet their reserve requirements (Cole and Slade, 1996, p. 53). A similar intervention (Sumarlin Shock II) was carried out in February 1991 when the rupiah once again came under pressure.

We now know that the monetary shocks of 1987 and 1991 were merely dress rehearsals for the 1997 crisis. Responding to domestically generated pressure on the rupiah, the two Sumarlin shocks succeeded in averting a destabilising loss of confidence in the currency. But the use of such crude measures signalled that the authorities had lost control over monetary policy, and that corrective measures were needed. The technocrats' inability, or failure, to heed these warnings in the end proved fatal.

3. Conclusion and prospects

Indonesia was destined to suffer a recession in 1997. Like Thailand, Korea and Malaysia, Indonesia maintained an open capital account and had accumulated short-term dollar-

[1] Named for then Acting Finance Minister J. B. Sumarlin.
[2] *Surat berharga pasar uang*, or SBPU.

denominated debt in excess of international reserves. All four countries were therefore vulnerable to a sudden change in market sentiment. When the change came it came quickly, and on a scale previously unimagined, let alone experienced in the region.

Yet, as we have argued in this essay, the intensity of the Indonesian crisis cannot be explained by external factors alone. The attempt to implement a radical programme of financial liberalisation in the context of deeply entrenched patrimonial state structures increased the likelihood of collapse, while at the same time undermining the mechanisms needed to restore stability. Far from dismantling the patronage networks that tied capitalists to the regime, liberalisation expanded the range of opportunities available to these groups to profit from their political connections. Meanwhile, the weakness of state oversight, regulation and enforcement enabled them to socialise the risks of these new ventures, particularly in the banking sector.

Indonesia now faces the immediate problem of reversing the descent into economic disintegration propelled by the implosion of the financial system. Indonesia also shares with Thailand and Korea a poorly designed IMF programme, most notably the bungled bank liquidation and a failure to shift from an orthodox tight money policy despite the absence of a credible strengthening of the currency over a period of eight months. It has yet to be demonstrated, for example, that the interest rate still has the power to exert upward pressure on the rupiah, given the extent of corporate bankruptcies and the collapse of the banking system. Moreover, there seems little point to maintaining an open capital account in a country that is unlikely to attract new, voluntary commercial lending. Based on humanitarian considerations alone, the IMF should now consider sacrificing ideological purity in favour of experimenting with more innovative approaches to the crisis (see, for example, Wade and Veneroso, 1998). This is likely to involve a full or partial closing of the capital account, a relaxation of monetary policy and lower interest rates. The IMF should also take direct responsibility for organising an orderly rescheduling of Indonesia's overseas private debt. Government targeting of strategic export industries—for example, industries in imminent danger of losing hard-won markets in the US and Europe—is also urgently needed. Acceleration of bank restructuring, including mergers, closings and selected nationalisations, should be given the highest priority.

Realistically, this is not likely to occur. Just as improbable are new initiatives from the Habibie Government to redirect the recovery effort. Widely viewed as a transitional figure, President Habibie lacks the legitimacy and independent power base required to effect a major change in policy. Having come to power on his predecessor's coat-tails, he represents a continuation of the political uncertainty that has marked Indonesian politics since the onset of the crisis.

Over the longer term, the country's future hinges largely on the formation of new political structures and traditions that can accommodate the country's tremendous diversity while avoiding a descent into sectarianism or mindless nationalism. This will not be an easy task. Thirty years of depoliticisation under Suharto leave behind a legacy of bureaucratic coercion and a woefully impoverished political culture. Ethnic and religious intolerance, skilfully manipulated by Suharto to weaken his opponents, remains a serious obstacle to reform. The severity of these problems was evident in the brutality directed at the Chinese–Indonesian community during the May riots (Schwarz, 1998), and the inability of opposition leaders to present a unified front against Suharto despite their shared moral revulsion at the scale of the regime's venality.

Driven by these moral concerns, Indonesia's first attempts to reinterpret the Suharto years have focused largely on the 'corruption, collusion and nepotism' of the President's family. This is understandable, given the years of enforced deference to Suharto (opposition figures were routinely imprisoned for 'insulting' the President) and the severity of the economic depression. But condemnation of the Suharto family will not substitute for more careful analyses of the country's political economy. Suharto may have engineered his New Order regime—and profited handsomely from it—but he was not alone. A cheap, politically disenfranchised labour force, low and easily evaded taxes and flexible rules underpinned the fortunes of a wide swathe of the capitalist class extending well beyond the President's inner circle. The regime's functionaries extracted their share of the spoils through a tight web of patron–client relations that reached from the presidential palace to the lowliest village chief. 'Cronyism', far from existing as an aberration, was (and is) the predominant mode of accumulation.

One of the many dangers facing post-Suharto Indonesia is that no real alternative to this system will emerge, and that faces will change but the methods remain the same. For some, including the Bretton Woods agencies, an accelerated programme of economic liberalisation is the most attractive option. The 1980s shibboleth that 'government failure is always worse than market failure' appears at first glance to offer a simple solution to the twin problems of state incapacity and patrimonialism. But, alas, some things are in fact too good to be true. If we have learned anything from the Indonesian crisis it is that where governments fail, markets are bound to fail as well sooner or later. The idea that economic liberalisation is a substitute for a fair and effective state is a dangerous fallacy, and one that Indonesia's new leaders should resist at all costs.

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